REPORT BY THE

AUDITOR GENERAL

OF CALIFORNIA

A REVIEW OF NURSING HOMES' COSTS

P-455.1

MARCH 1985

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Honorable Art Agnos, Chairman
Members, Joint Legislative
Audit Committee
State Capitol, Room 3151
Sacramento, California 95814

Dear Mr. Chairman and Members:

The Office of the Auditor General presents its report concerning nursing home operators' distribution of Medi-Cal cost-of-living allowances for increased labor costs. The report also addresses nursing home operators' expenditures of Medi-Cal funds for products or services that are not related to providing patient care or that are in excess of "reasonable" cost as defined by Medi-Cal guidelines.

Respectfully submitted,

Thomas W. Hayes

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Auditor General

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SUMMARY

Nursing home operators do not always use a proportionate share of the Medi-Cal reimbursements to cover increased labor costs. Eight of the 20 nursing homes we surveyed (40 percent) did not use a proportionate share of their increased Medi-Cal revenues for increased labor costs. Neither state laws nor regulations require nursing home operators to use a proportionate share of their Medi-Cal revenues for specific purposes. In addition, some nursing home operators spend money for personal travel, entertainment, and automobiles and attempt to obtain reimbursement from the Medi-Cal program for these expenses. According to the department's fiscal year 1981-82 audit of 16 percent of the nursing home population, inappropriately claimed expenses amounted to $6 million (3.5 percent) of all expenses claimed by the sampled nursing homes. Expenditures for items not related to patient care or in excess of the reasonable cost to provide such care are not included in the Medi-Cal reimbursement rate.

Distribution of the Medi-Cal Cost-of-Living Allowance

From fiscal year 1981-82 to fiscal year 1982-83, the 20 nursing homes in our sample received an average Medi-Cal cost-of-living allowance (COLA) of $.94 per patient day. Based on the number of Medi-Cal patients that these nursing homes served, the Medi-Cal COLA resulted in increased revenues of approximately $438,000. According to the formula we developed to determine if nursing home operators distributed a proportionate share of their Medi-Cal COLAs to pay for increased labor costs, $280,000 (64 percent) of the $438,000 increase in Medi-Cal revenues should have been allocated to labor costs. In fiscal year 1982-83, the actual increase in total wages for the 20 nursing homes in our sample was $398,000. Nursing homes' nonadministrative employees, who accounted for approximately 75 percent of the actual hours worked in these nursing homes in 1983, received

only 56 percent ($221,000) of the money that the 20 nursing home operators spent for increased wages. Nonadministrative employees, for the purposes of this analysis, include nonsupervisory, unlicensed employees; they include nurse assistants, and dietary, maintenance, laundry, and janitorial workers.

Costs That Are Unreasonable and Unrelated to Providing Patient Care

Nursing home operators spend Medi-Cal funds for products and services that are not related to providing patient care or whose costs exceed "reasonable" cost as defined by Medi-Cal guidelines. In our sample, we found expenses for personal items, such as automobiles, travel, and entertainment, that were not related to providing patient care. These expenses totaled $138,836. One nursing home operator, for example, listed as nursing home costs $7,861 in credit card charges that could not be documented as business-related expenses. We also found examples of expenditures that nursing homes reported as being Medi-Cal reimbursable that were, in fact, higher than the amounts that Medi-Cal criteria define as "reasonable" for providing service to patients. In our sample, these incorrectly reported expenditures totaled $495,275. One nursing home operator, for example, reported $131,090 in administrative costs that were subsequently disallowed by the Department of Health Services' auditors.

Nursing home operators are required to report all costs in their annual cost reports and to segregate costs that are not allowable for Medi-Cal reimbursement from costs that are allowable. However, state laws do not limit the types of expenditures that nursing home operators make.

Recommendations

If the Legislature intends that nursing homes distribute Medi-Cal cost-of-living allowances proportionately, the Legislature should clarify and strengthen the laws concerning the distribution of Medi-Cal funds to nursing home employees. Moreover, if the Legislature intends to ensure that nursing home operators report their Medi-Cal costs accurately, the Legislature should authorize sanctions against nursing home operators who repeatedly overstate their Medi-Cal costs.

INTRODUCTION

The Department of Health Services (department), through its Rate Development Branch, is responsible for recommending Medi-Cal reimbursement rates to the Legislature for approximately 1,270 long-term health care facilities that are capable of providing care to over 109,800 patients. In general, long-term health care facilities, commonly known as "nursing homes," offer 24-hour skilled nursing services and may also provide supportive, restorative, and preventive health services to California's chronically ill or convalescent patients.

In 1983, approximately 99.5 percent of all nursing homes were privately owned and operated. Nursing homes may be organized as corporations, partnerships, or proprietorships (single owner). Corporations may be profit or nonprofit, and they may be part of a corporate chain, part of a division of a corporation, or owned by a family or a trust. The State pays nursing home operators a predetermined rate per day for each Medi-Cal patient the nursing home serves. The cost of providing service to a Medi-Cal patient does not directly determine the reimbursement that a nursing home operator receives for that patient. Instead, the reimbursement rate is based on the median cost (midpoint) of nursing homes throughout the State. Medi-Cal reimbursement rates vary slightly by the size and the location of the nursing home. In fiscal year 1982-83, Medi-Cal reimbursement rates ranged from $34.68 to $40.71 per patient day for the 20 nursing

homes in our sample. Medi-Cal funds, consisting of approximately 50 percent state and 50 percent federal monies, accounted for over 62 percent of nursing homes' total revenues in 1983. Private patient fees, Medicare, and insurance payments made up the remaining 38 percent.

Although many laws regulate the quality of care that nursing homes must provide to meet state licensing requirements, no laws or regulations limit the types of expenditures that nursing home operators make. Likewise, few laws regulate operators' use of Medi-Cal funds. However, the State does require nursing home operators to show their revenues and costs by filing annual reports with the California Health Facilities Commission.

Nursing Homes' Reporting Responsibilities

Under the provisions of the California Health Facilities Disclosure Act, all nursing homes must file annual reports of revenues and costs with the California Health Facilities Commission within four months after the close of their fiscal years. The purpose of this system of reporting is to establish financial comparability among nursing homes. The department's Rate Development Branch uses the reported costs to analyze changes in costs. To comply with the State's reporting requirements, nursing home operators must report all costs and segregate them into two categories: those costs that are "allowable" for Medi-Cal reimbursement and those costs that are "not

allowable" for Medi-Cal reimbursement because they do not contribute to the health care of patients. Federal Medicaid regulations are the standard that nursing home operators use to determine costs that are allowable for Medi-Cal reimbursement.

The department's Rate Development Branch analyzes the increase in allowable costs that nursing homes throughout the State report to the California Health Facilities Commission. It then makes recommendations to the Legislature each year regarding Medi-Cal rates. These recommendations include an appropriate cost-of-living allowance (COLA) that nursing home operators will receive for the care of Medi-Cal patients.

Laws and Regulations Governing Nursing Homes' Use of Funds

Chapter 19, Statutes of 1978, provided for an additional Medi-Cal reimbursement of $2.28 per day for each Medi-Cal patient in a nursing home. The statute required that nursing home operators pass this entire increase on to their nonadministrative employees by raising the beginning wage and by making one incremental increase in the hourly wage after three months. Section 51510 of Title 22 of the California Administrative Code, issued in 1978, provided an additional Medi-Cal reimbursement to nursing home operators to pay $.20 more per hour to nurse assistants once they complete a required training course and become certified nurse assistants. Because these wage supplements are required by statutes and regulations, they are included in the cost

factors that the department uses to determine the daily Medi-Cal reimbursement rate paid to nursing home operators.

SCOPE AND METHODOLOGY

This audit sought to determine whether nursing home operators granted employees cost-of-living allowances that were proportionate to the annual cost-of-living allowances that nursing home operators received from the Medi-Cal program in fiscal year 1982-83. We also determined whether nursing home operators used any of their funds, Medi-Cal or other, for purposes unrelated to providing patient care.

To obtain the information we present in this report, we judgmentally selected 20 from a universe of 956 nursing homes that care for Medi-Cal patients throughout California. To be able to compare costs, we also limited our selection to skilled nursing facilities, which represent approximately 91 percent of the nursing homes in California. We also chose nursing homes at least one-half of whose patients were covered by the Medi-Cal program. The nursing homes we selected reflected the characteristics of the nursing home sample that the department uses to establish Medi-Cal reimbursement rates. We chose nursing homes with various forms of ownership, including corporations, partnerships, and proprietorships, and we also considered

the size and location of each nursing home.* Finally, we restricted our sample to those nursing homes that the department had audited for the fiscal or calendar year ending no later than December 31, 1982.

We reviewed the Medi-Cal cost reports that each nursing home submitted to the California Health Facilities Commission for fiscal years 1981-82 and 1982-83. We verified that the costs and revenues that the nursing homes reported agreed with the nursing homes' financial records. Using these data, we computed the changes in costs as well as the changes in revenues by source from fiscal year 1981-82 to fiscal year 1982-83.

We also tested payroll records at the nursing homes to determine the increases in pay that individual nonadministrative employees received. Nonadministrative employees, for the purposes of this analysis, are nonsupervisory, unlicensed employees; this category includes nurse assistants, and dietary, maintenance, laundry, and janitorial workers. We then applied a formula to determine if nursing home operators granted employees a "proportionate share" of the fiscal year 1982-83 Medi-Cal cost-of-living allowance. (Appendix A explains how we developed this formula.)

*According to the sample that the department uses to establish Medi-Cal reimbursement rates, 31 percent of the total nursing homes have from one to 59 beds, and 69 percent have from 60 to 299 beds.

Finally, we reviewed the department's audit reports to determine whether nursing home operators used funds for purposes that are unrelated to providing patient care. We also noted expenditures that, according to Medi-Cal guidelines, exceeded the "reasonable" cost of providing patient care. Based on our fieldwork, we documented examples of nursing home expenditures that were excessive or unrelated to providing patient care.

We interviewed nursing home owners and administrators and officials in the department's Audits Branch and Rate Development Branch. We also interviewed a representative of the California Association of Health Facilities, the nursing home industry's advocate to obtain the industry's perspective on increases in nursing home costs.

AUDIT RESULTS

I

DISTRIBUTION OF MEDI-CAL COST-OF-LIVING ALLOWANCES TO NURSING HOME EMPLOYEES

Nursing home operators do not always grant a proportionate share of Medi-Cal cost-of-living allowances (COLAs) to cover increased labor costs. Eight of the 20 nursing homes we surveyed (40 percent) did not use a proportionate share of the Medi-Cal COLA to cover the costs of increased salaries, wages, and benefits (labor costs). Current laws and regulations do not require nursing home operators to use a proportionate share of their Medi-Cal revenues for specific purposes. Nonadministrative employees, who accounted for approximately 75 percent of the actual hours worked at the nursing homes in our sample, received only 56 percent of the total that nursing home operators spent on increased wages. Payments to owners and parent organizations for administrative and management services were higher on the average for those nursing homes that did not use a proportionate share of the Medi-Cal COLA for increased labor costs.

Changes in Nursing Home Revenues and Costs

The 20 nursing homes in our sample received approximately 70 percent of their revenues for skilled nursing care from the Medi-Cal program. Between fiscal year 1981-82 and fiscal year 1982-83, the

Medi-Cal COLA added revenues of $438,000. Labor costs constituted approximately 64 percent of nursing homes' total costs. Labor costs increased by $758,000 (4.6 percent) between 1981-82 and 1982-83.*

Our review of the financial records at 20 nursing homes showed that they received an average Medi-Cal COLA of $.94 per patient day from 1981-82 to 1982-83. Based on the total number of Medi-Cal patients that the nursing homes served in 1982-83, the COLA resulted in increased revenues of approximately $438,000. For this same period, revenues from private patient fees, the other major source of nursing home revenues, rose by approximately $902,000, an average increase of $3.81 per patient day.

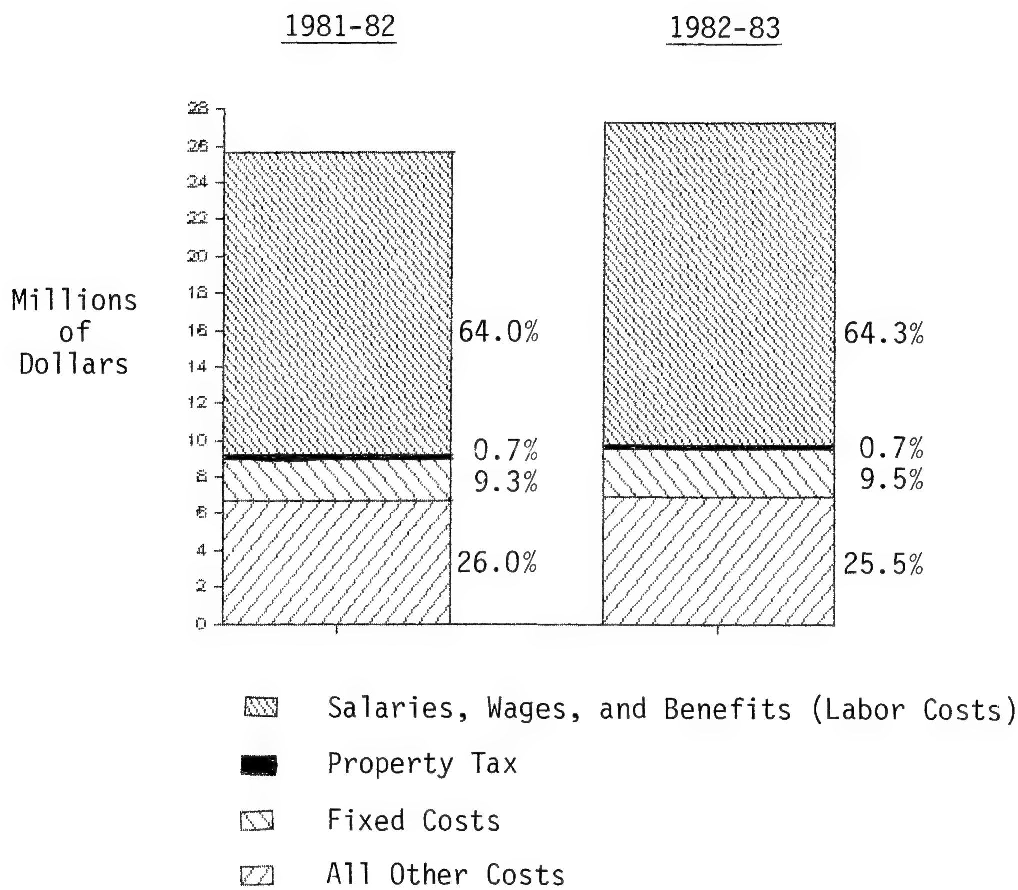
The services that nursing homes provide are primarily skilled nursing services provided to patients based on physicians' orders. These services provide patients with required convalescent or restorative care. Revenues for skilled nursing services come from various sources: Medi-Cal reimbursements, private insurance, private patient fees, Medicare, and veterans' assistance. The 20 nursing homes that we visited received approximately 70 percent of their revenues for skilled nursing services from Medi-Cal reimbursements. Nursing homes also receive revenues for ancillary services such as physical therapy and pharmacy. Charges for these services are not included in the charges for skilled nursing care.

*Unless otherwise noted, all references to years are fiscal years.

Using the cost reports that nursing homes file with the California Health Facilities Commission, the Department of Health Services (department) separates the nursing home costs that are allowable for Medi-Cal reimbursement into four components: salaries, wages, and benefit costs (labor costs); property tax; fixed costs; and "all other costs." We used the same categories to classify total costs for the 20 nursing homes in our sample. Labor costs constituted approximately 64 percent of the total costs. Property taxes were negligible, about one percent of total costs. Fixed costs, including the costs of owning or renting buildings, accounted for approximately 9 percent of total costs. "All other costs," which include administrative costs and items such as food and supplies, accounted for the remaining 26 percent. The following graph depicts the four cost components in relation to total costs for the 20 nursing homes in our sample.

GRAPH 1

NURSING HOME COST COMPONENTS AS A PERCENTAGE OF TOTAL COST FISCAL YEARS 1981-82 AND 1982-83



As the graph shows, the relative proportion of costs remained fairly stable over this two-year period. Total costs for the 20 nursing homes increased by $1.2 million (4.9 percent) from 1981-82 to 1982-83. Labor costs increased by $758,000 (4.6 percent), property taxes remained

approximately the same, fixed costs increased by $202,000 (8.5 percent), and "all other costs" increased by $285,000 (4.3 percent). (A comparison of changes in actual costs per patient day for each component of nursing home costs from 1981-82 to 1982-83 is presented in Appendix B.)

The Relationship Between Increases in Medi-Cal Revenues and Changes in Labor Costs for Nonadministrative Employees

Eight of the 20 nursing homes that we surveyed (40 percent) did not use a proportionate share of the increase in Medi-Cal revenues to cover increased labor costs. The nonadministrative employees at these 20 nursing homes, whose average wage in 1982-83 after at least one year on the job was $4.34 per hour, received an increase of $.17 (4.2 percent) in their hourly wage. Nonadministrative employees, who accounted for approximately 75 percent of the actual hours worked in nursing homes, received only 56 percent of the total that nursing home operators spent on increased wages.

Examining the relationship between increases in Medi-Cal revenues and changes in labor costs for nonadministrative employees involved three steps: (1) comparing total increases in Medi-Cal revenues to total increases in labor costs to determine the "proportionate share"; (2) determining whether individual nursing homes in the sample used a proportionate share of the Medi-Cal COLA for increased labor costs; and (3) determining if the Medi-Cal COLA was reflected in the wages paid to nonadministrative employees.

Comparison of Increases in Medi-Cal Revenues to Increases in Labor Costs

The 20 nursing homes in our sample received an average Medi-Cal COLA of $.94 per patient day. Based on the total number of patient days that Medi-Cal paid for in 1982-83, the 20 nursing homes received a total of $438,000 in additional Medi-Cal revenues to distribute to the four cost components. According to the formula we developed to determine if nursing home operators used a proportionate share of their Medi-Cal COLAs to pay for increased labor costs, $280,000 (64 percent) of the $438,000 increase in Medi-Cal revenues should have been allocated to labor costs.

From 1981-82 to 1982-83, the nursing homes' labor costs increased by approximately $758,000.* Increased wages accounted for $398,000 of the increase in labor costs. Nonadministrative employees received $221,000 (56 percent) of the amount that nursing home operators spent for increased wages. These nonadministrative employees, who accounted for approximately 75 percent of the actual hours worked in the 20 nursing homes in our sample, received 56 percent of what was spent for increased wages.

*This does not include $335,000 charged to benefit costs as the result of changes in the method of accounting for workers' compensation insurance and other benefits at two nursing homes.

Nursing homes spent the remaining $360,000 to pay for increases in the cost of benefits. These costs include payroll taxes and workers' compensation insurance as well as employers' contributions for sick leave, vacation pay, and health insurance for all employees. We did not isolate the increases in the cost of benefits paid to nonadministrative employees because the nursing homes' accounting systems did not provide this detail. Benefits for employees of small nursing homes (one to 59 beds) increased from 15.2 percent of total labor costs to 16.1 percent of total labor costs. Benefits for employees at large nursing homes (60 to 299 beds) increased from 16.4 percent of total labor costs to 17.9 percent of total labor costs.

Changes in employee turnover rates affect nursing homes' labor costs. Data for employee turnover for the industry show that employee turnover occurs in one-half of the employee population. Employee turnover rates at the 20 nursing homes in our sample averaged 109 percent in 1981-82 and 87 percent in 1982-83. High employee turnover results in lower overall labor costs because new employees receive only the state-mandated minimum wage.

"Proportionate Shares" at Individual Nursing Homes

The second step in examining the relationship between changes in Medi-Cal revenues and changes in labor costs was to determine if the nursing homes applied a proportionate share of their Medi-Cal COLAs toward increased labor costs. We found that 12 of the 20 nursing homes

(60 percent) used a proportionate share of their Medi-Cal COLAs to cover increased labor costs in 1982-83.

All eight of the nursing homes that failed to use a proportionate share of the Medi-Cal COLA to cover labor costs were proprietorships or closely held corporations that were owned and managed by one or two people. Five of these eight nursing homes were small, averaging 35 beds. Ten of the 12 nursing homes that used a proportionate share of their Medi-Cal COLAs to cover increased labor costs were larger nursing homes, averaging 135 beds.

Medi-Cal COLA Reflected in Wages Paid to Nonadministrative Employees

The third step in our analysis of increases in Medi-Cal revenues and increases in labor costs was to determine the effect of Medi-Cal COLAs on the wages that nursing home operators paid to nonadministrative employees. We define nonadministrative employees as nonsupervisory, unlicensed employees that include nurse assistants, and dietary, maintenance, laundry, and janitorial workers. Nurse assistants, who give personal care to patients, provide approximately 67 percent of the nonadministrative services at the nursing homes in our sample.

To determine the wage increases received by individual nonadministrative employees, we sampled the nursing homes' payroll records for 1981-82 and 1982-83 and compared the changes in employees'

pay rates. Nonadministrative employees in our sample received an average increase of $.17 (4.2 percent) per hour in 1982-83. The pay raises ranged from zero to 20 percent in 1982-83; some of these raises were required by law. The average wage for those employees who remained on the job for at least one year was $4.34 per hour in 1982-83. Table 1 shows the average wage increases, by size of nursing home, for nonadministrative employees for the 20 nursing homes in our sample. (Appendix C shows the average wage increases for each nursing home in our sample.)

TABLE 1

AVERAGE INCREASES IN HOURLY WAGE FOR NONADMINISTRATIVE EMPLOYEES BY SIZE OF NURSING HOME FISCAL YEAR 1981-82 TO 1982-83

	Number of Homes	Increase	Percent
1-59 Beds	7	$.10	2.6
60-299 Beds	13	$.21	5.1
Average		$.17	4.2

Averages for nursing homes throughout the State in 1982-83 show that plant operations and maintenance workers are the highest paid nonadministrative employees, receiving an average of $5.72 per hour. Dietary workers receive $4.63 per hour, nursing assistants receive $4.32 per hour, and housekeeping workers receive $4.31 per hour. Laundry employees are paid the lowest average wage, $4.24 per hour.

The nursing homes in our sample, on the average, also paid the highest wages to plant operations employees and the lowest wages to laundry employees.

The increase that individual employees actually received was directly related to the size of the nursing home; the amount of the increase was not related to whether nursing home operators used a proportionate share of the Medi-Cal COLA to pay for increases in labor costs. Our analysis of the payroll records at the 13 large nursing homes in our sample (60-299 beds) indicated that, in 1982-83, they paid an average wage increase of $.21 per hour (5.1 percent) to those nonadministrative employees who had stayed on the job for at least one year. Of these 13 nursing homes, 3 failed to use a proportionate share of the Medi-Cal COLA for labor costs. These 3 nursing homes paid an average increase of $.20 per hour (4.9 percent) to the nonadministrative employees who stayed on the job for at least one year. The 7 small nursing homes in our sample (1-59 beds) paid nonadministrative employees an average wage increase of $.10 per hour (2.6 percent). The 5 small nursing homes that did not distribute a proportionate share paid an average wage increase of $.08 per hour (2.0 percent).

Compensation to Nursing Home Administrators and Owners

Administrators' salaries and owners' compensation vary according to the size of the nursing home. Administrators' salaries at

the small nursing homes (1-59 beds) averaged $23,252 in 1982-83, an increase of $1,293 (5.9 percent) over 1981-82. Administrators' salaries at the large nursing homes (60-299 beds) averaged $48,172 in 1982-83, an increase of $3,780 (8.5 percent) over 1981-82. Four of the large nursing homes had assistant administrators whose salaries averaged $25,040. Ten of the 20 nursing homes in our sample employ administrators who do not own any share of the business. Compensation to these administrators includes a salary and the benefits that an employee ordinarily receives. The following table shows the change in administrators' salaries from 1981-82 to 1982-83. (Appendix D presents the average change in administrators' salaries from 1981-82 to 1982-83 for each of the 20 nursing homes in our sample.)

TABLE 2

CHANGE IN NURSING HOME ADMINISTRATORS' SALARIES
BY SIZE OF NURSING HOME
FISCAL YEAR 1981-82 TO 1982-83

	Number of Homes	1981-82	1982-83	Change	Percent
1-59 Beds	7	$21,959	$23,252	$1,293	5.9
60-299 Beds	13	$44,392	$48,172	$3,780	8.5
Average		$36,540	$39,450	$2,910	8.0

Compensation to owners includes not only the salaries that they pay to themselves if they act as administrators but also the following amounts that owners and relatives of owners may receive: salaries, management fees, consulting fees, directors' fees, and

payments for such expenses as health and disability insurance, use of an automobile, travel, and entertainment. Payments made to owners or parent organizations vary according to the type of ownership. For example, the net income that a proprietorship earns is considered income for the owners. Nursing homes that are part of corporate chains may pay an amount to the parent company each year for administrative and management services. The following table shows the average payment to owners and parent organizations for administrative and management services and for other benefits for 1981-82 and 1982-83. (Appendix E presents the change in payments to the owners and parent organizations of the 20 nursing homes in our sample for administrative and management services and for benefits for 1981-82 and 1982-83.)

TABLE 3

CHANGE IN AVERAGE PAYMENT TO NURSING HOME OWNERS AND PARENT ORGANIZATIONS BY NURSING HOME SIZE FISCAL YEAR 1981-82 TO 1982-83

	Number of Homes	1981-82	1982-83	Change	Percent
1-59 Beds	7	$ 49,673	$ 48,594	$(1,079)	(2.2)
60-299 Beds	13	$110,327	$112,033	$ 1,706	1.5
Average		$ 89,098	$ 89,829	$ 731	0.8

The amount that owners and parent organizations of nursing homes received was generally commensurate with the size of the nursing home. However, nursing homes that did not use a proportionate share of

the Medi-Cal COLA for increased labor costs paid an average increase of 10.4 percent for administrative and management services in 1982-83. Nursing homes that did use a proportionate share of the Medi-Cal COLA for increased labor costs provided an average increase of 3.2 percent for administrative and management services.

The legal form of ownership (corporation, partnership, and proprietorship) predominantly determines the form of payment that owners or related organizations receive for administrative and management services. For example, a nursing home that is a division of a publicly held corporation pays a salary to its administrator and may pay its parent organization an amount for administrative and management services. At a 99-bed nursing home in northern California, which is a division of a publicly held corporation, the administrator received a salary of $23,774 in 1982. The nursing home also paid $115,399 for the administrative and management services that the parent organization provided.

For proprietorships, Medi-Cal guidelines recognize the net income of the business as compensation to the owner. Two nursing homes in our sample were proprietorships, owned by individuals who were also the administrators. In one of these proprietorships, a 19-bed nursing home in southern California, the owner reported a net income before taxes of $23,209 for 1982. However, the financial records of the nursing home show that the owner paid himself a salary of $22,000 and that he withdrew $16,710 in cash and he paid $1,098 for health and

disability insurance. In addition, department auditors found that the owner incurred $23,577 for personal travel and entertainment expense and for interest expense that the owner could not document as a business-related expense. Thus, the owner of this nursing home received economic benefits totaling $63,385.

CONCLUSION

Eight of the 20 nursing homes in our sample did not use a proportionate share of the Medi-Cal cost-of-living allowance for increased labor costs in 1982-83. Neither state laws nor regulations require nursing home operators to use a proportionate share of their Medi-Cal revenues for specific purposes. Nonadministrative employees received only 56 percent of the total that nursing home operators spent on increased wages even though these employees accounted for 75 percent of the actual hours worked at these nursing homes. Wage increases to nonadministrative employees varied according to the size of the nursing home. The amount that owners and parent organizations of nursing homes received was also generally commensurate with the size of the nursing home. However, nursing homes that failed to use a proportionate share of the Medi-Cal COLA for increased labor costs paid an average increase of 10.4 percent for administrative and management services compared to a 3.2 percent average increase in nursing homes that did use a proportionate share of the Medi-Cal COLA.

RECOMMENDATION

If the Legislature intends that Medi-Cal cost-of-living allowances be distributed proportionately to nursing home employees, then the Legislature needs to strengthen and clarify the laws concerning the distribution of Medi-Cal funds to these employees.

II

COSTS THAT ARE UNREASONABLE OR UNRELATED TO PROVIDING PATIENT CARE

Nursing home operators spend Medi-Cal funds for products and services that are not related to caring for patients or that are in excess of reasonable costs as defined by Medi-Cal guidelines. In 1981-82, nursing homes in our sample spent a total of $138,836 for personal items, such as automobiles, travel, and entertainment, that were not related to providing patient care. One nursing home operator, for example, listed as nursing home costs $7,861 in credit card charges that could not be documented as business-related expenses. Moreover, Department of Health Services (department) auditors found expenditures totaling $495,275 that were reported as Medi-Cal costs but that exceeded reasonable costs as defined by Medi-Cal guidelines. In one instance, the department's auditors disallowed $131,090 for one nursing home's administrative costs because they were excessive. Although some nursing home operators attempt to obtain Medi-Cal reimbursement for these expenses, the department's audits result in adjustments to exclude costs that are not related to patient care or that exceed the reasonable cost of providing such care.

In establishing the Medi-Cal cost-of-living allowance (COLA), the department must take into account nursing home operators who fail to segregate costs that are not allowable for Medi-Cal reimbursement from those costs that are allowable. To do this, the department

annually audits a statistical sample of cost reports that nursing homes submit to the California Health Facilities Commission. The department compares the costs that the nursing homes in the audit sample reported as allowable for Medi-Cal reimbursement with the costs that the department's auditors found to be allowable for Medi-Cal reimbursement. The department subsequently reduces the total costs that nursing home operators reported to reflect only those costs that the audit sample showed were actually associated with providing health care to patients. From this adjusted base, the department determines the Medi-Cal COLA.

According to the department's audits of approximately 16 percent of the State's nursing homes in 1981-82, nursing homes in the sample failed to segregate approximately $6 million (3.5 percent) of costs that were not allowable for Medi-Cal reimbursement. In our sample of 20 nursing homes, the department's auditors found approximately $863,000 (4 percent) that nursing home operators should have segregated because the costs were not allowable for Medi-Cal reimbursement. According to the department's audit records, nursing home operators who are audited each year have consistently reported 3 to 5 percent of total costs as allowable for Medi-Cal reimbursement when they were not.

Costs Unrelated to Providing Patient Care

For 1981-82, the department's auditors found that nursing home operators in our sample, or the management companies they employ, spent

$138,836 on personal expenditures, such as automobiles, travel, and entertainment. These expenditures were not related to the cost of providing care to nursing home patients.

For example, one of the cases we found in the department's audit records involved a 147-bed nursing home in southern California owned by a parent corporation that is a nonprofit corporation. This nursing home contracts with a management services company for its management and operations. The executive director of the management services company is a former employee of the parent corporation. The contract for management services provides for annual fees of $180,000, an automobile, and payment of all business-related expenses incurred by the executive director of the management services company. In addition, the nursing home paid for all of the entertainment and public relations expenses incurred by the management services company's executive director. For 1981-82, the department's auditor disallowed $30,800 in management fees because they exceeded the cost of providing management services. The department's auditor also disallowed $7,861 in credit card charges that the management services company's executive director had made because these charges could not be documented as business related.

Because the department has not yet audited this nursing home's financial records for 1982-83, we reviewed five months' of credit card charges signed or authorized by the executive director of the management services company. These charges totaled $9,827 and

represented approximately one-half of the executive director's credit card charges for 1982-83. At least $7,400 (75 percent) of the charges we reviewed were unrelated to providing patient care. For example, the executive director served as a director of an association. According to the association, the position of director is unpaid, but directors are entitled to reimbursement for expenses incurred on behalf of the association, up to $70 per day. Despite the association's provisions, the executive director of the nursing home's management services company charged $693 to the nursing home's travel account for travel related to activities of the association.

The parent corporation that owns this nursing home was considering the acquisition of another nursing home in 1983. The parent corporation authorized the executive director of the management services company to act on its behalf. The executive director charged $982 at a private dinner and show club in southern California and classified this charge under "financing" for the second nursing home.

We also found that nursing home operators or the management companies they employ have borrowed funds for personal use and for other purposes unrelated to providing patient care. At the end of 1982-83, 7 of the 20 nursing homes had outstanding loans, totaling $473,171, to owners or to members of their management companies.

For example, a 59-bed nursing home in southern California is a family-held corporation that employs a management company that is owned

and operated by the father of the owners of the nursing home. The owner of the management company provides day-to-day business, property management, and maintenance services. The owner of the management company borrowed money interest free from the nursing home. This loan, which is not reflected in any of the nursing homes' costs, reduces the funds available for patient care. The balance due from this loan increased from $34,500 at the end of 1981-82 to $64,500 at the end of 1982-83; however, the balance fluctuated because the owner of the management company continued to borrow over the two-year period. The average balance of the outstanding loan over this period was $151,000. There were no promissory notes formalizing the loan.

Unreasonable Costs

We reviewed the department's 1981-82 audits of the 20 nursing homes in our sample and found that the department's auditors disallowed $495,275 in expenses because they exceeded the "reasonable" cost of providing services to patients. This amount includes the cost of such items as owners' compensation and payments for management services.

According to Medi-Cal cost guidelines, "reasonable" means that the compensation paid to an administrator who is an owner should be comparable to the compensation that ordinarily would be paid to another administrator in similar circumstances. Reasonable compensation is also limited to the fair market value of the services that the administrator rendered in connection with providing patient care. Fair

market value depends upon the need for and the availability of these services in the nursing home industry. Other factors affecting the reasonableness of compensation are the size of a nursing home, the types and range of services that the nursing home offers, the number and types of personnel that the nursing home employs, its geographical location, the qualifications of the administrator such as education and experience, and the nature of the administrator's duties. Finally, the services that the administrator provides must be necessary to the function of the nursing home.

We reviewed the department's 1981-82 audit reports for the nursing homes in our sample and found that 9 of the 20 nursing homes failed to report owners' compensation that exceeded what Medi-Cal guidelines consider reasonable. The excess expenditures for these 9 nursing homes totaled $419,499. One example we found involved a 122-bed nursing home in southern California that is organized as a corporation and that is owned by two shareholders. The president of the corporation holds a 63.5 percent interest in the nursing home. He reported that he spent an average of 5 hours per week at the nursing home, and he received $32,000 in compensation for 1982. The secretary-treasurer, who holds a 36.5 percent interest in the corporation, acted as the full-time administrator and received a salary of $92,300 plus $4,941 for travel expenses. An assistant administrator, who is not an owner, worked 40 hours per week and was paid $39,700. The department's auditor disallowed a total of $131,090 of this nursing home's costs because the compensation to the owners and

to the administrator, taken together, exceeded what was considered a reasonable cost for providing the services of an administrator.

CONCLUSION

Nursing home operators are reporting as allowable for Medi-Cal reimbursement costs that are neither related to providing patient care nor reasonable according to Medi-Cal guidelines. The Department of Health Services' auditors found that nursing home operators improperly report from 3 to 5 percent of their costs each year. In 1981-82, the 20 nursing homes in our sample failed to segregate approximately $863,000 in costs that were not allowable for Medi-Cal reimbursement. The department's audit of a sample of nursing homes throughout the State identified $6.0 million in costs that nursing homes should not have included as allowable for Medi-Cal reimbursement. Expenditures for items not related to patient care or in excess of the reasonable cost to provide such care are not included in the Medi-Cal reimbursement rate.

RECOMMENDATION

If the Legislature intends to ensure that nursing home operators accurately report their Medi-Cal costs, then the Legislature should authorize sanctions against nursing home operators who repeatedly overstate their Medi-Cal costs.

We conducted this review under the authority vested in the Auditor General by Section 10500 _et seq_. of the California Government Code and according to generally accepted governmental auditing standards. We limited our review to those areas specified in the audit scope section of this report.

Respectfully submitted,

THOMAS W. HAYES
Auditor General

Date: February 19, 1985

Staff: Robert E. Christophel, Audit Manager
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GEORGE DEUKMEJIAN, *Governor*

STATE OF CALIFORNIA

HEALTH and WELFARE AGENCY

OFFICE OF THE SECRETARY
1600 NINTH STREET, ROOM 460
Sacramento, California 95814
(916) 445-6951

February 19, 1985

Mr. Thomas W. Hayes
Auditor General
Office of the Auditor General
660 J Street, Suite 300
Sacramento, CA 95814

Dear Mr. Hayes:

We have reviewed the draft of the report P-455.1 "A Review of Nursing Home Costs" February 1985. As a result of this review, we offer the following:

We cannot comment on the specific numbers in the charts and graphs since we did not have the back-up documents to review. Specifically, we also note that:

	Page	Paragraph	Comments
1.	2	2	Federal guidelines are used to determine allowable costs. We recommend changing this wording. 1 *
2.	2	3	There are State regulations that require all long-term care facilities participating in the Medi-Cal program to submit annual cost reports. This also should be revised. 2
3.	3	1	This seems to contradict No. 1 above. 3
4.	4	top of page	Should probably also say that after such special rate increases are given and the facilities start reporting the increased costs, the wage pass-through ends up built into their base costs and subsequent rates. 4
5.	6	2	CAHF is only one industry representative, and while it is the largest and most vocal, there are others. Suggest this be amended to say that "CAHF is the largest association representing the nursing home industry."

* The Auditor General's comments on specific points contained in the agency's response appear on page 35.

	Page	Paragraph	Comments
6.	11	top of page	Might have tried to explain the big difference in increases (8.5 vs 4.3). 5 The big increase in fixed costs could be due to lease-back arrangements. It was this concern that prompted the federal government to mandate that states initiate some controls.
7.	13	1	Not being able to separate non-administrative employee benefits could distort this figure significantly. 6 Since the report suggests the lower paid employees (non-administrative) receive lower percentage of wage increases, it would stand to reason these same employees would receive a lower percentage of benefits. Also, it is interesting to note that CAHF has contended that they pay 28% benefits. This study indicates something in the 16% range might be more appropriate.
8.	13	2	It is potentially financially advantageous to the nursing homes to have a high personnel turnover, since they can then hire at the lowest wage level. (This creates a bonus for the facilities on a one-time basis.)
9.	15	1	The report claims a 4.2% wage increase. However, 9% was actually used applied to 69% of their total costs for wages and benefits to develop the 82-83 COLA. The extra 3% (4.8% of 64%) is unaccounted for as a wage increase. This represents approximately $1.10 a patient day that could be used as additional profit. 7
10.	23	1	Recommend the last sentence be revised to reflect that unallowable costs added to cost reports raise the reimbursement for all operators, since the rate is based on medians. The present wording could be misleading in that it could be taken that an operator would get reimbursed directly for all of these unallowable costs if not caught by an audit.

Thank you for sharing this draft with us and for providing the opportunity to respond. Should you have any questions, please direct them to Sue Staats,

Chief of the Department of Health Services' Medi-Cal Policy Division at 5-6141, or Dr. Jack W. Patwell, Chief of the Department's Rate Development Branch on 5-8128.

Sincerely,

Carole Hood for

DAVID B. SWOAP
Secretary

AUDITOR GENERAL'S COMMENTS ON THE HEALTH AND WELFARE AGENCY'S RESPONSE

1. We state this on page 3, paragraph 1.

2. We state this on page 2, paragraph 2.

3. On page 2, paragraph 2, we describe the state reporting requirements and how nursing home operators may use their funds. On page 3, paragraph 1, we state that federal Medicaid regulations are the standard that nursing home operators use to determine costs allowable for Medi-Cal reimbursement. These statements are not contradictory.

4. We state this on page 3, paragraph 3.

5. Fixed costs represent less than 10 percent of total nursing home costs. This report focuses on labor costs.

6. On page 13, paragraph 1, we state that we did not isolate the increases in the cost of benefits paid to nonadministrative employees because the nursing homes' accounting systems did not provide this detail. Since benefits for all employees increased by only 1 to 1.5 percent of total labor cost, we find no distortion.

7. The 4.2 percent wage increase refers to our test of payroll records to determine the wage increases to individual nonadministrative employees. Although the department may have allowed a 9 percent increase in labor costs in the calculation of the reimbursement rate, nursing home operators are not required to grant any increase in salaries, wages, and benefits (labor costs). In addition, our review of actual increases in Medi-Cal revenue at these 20 nursing homes showed an average increase of $.94 per patient day which clearly could not include an extra $1.10 per patient day profit.

APPENDIX A

ASSUMPTIONS AND FORMULA USED TO DETERMINE PROPORTIONATE SHARE OF THE MEDI-CAL COLA

In determining whether nursing home operators distributed a "proportionate share" of their Medi-Cal cost-of-living allowance (COLA), we developed a formula based on two principal factors: the change in the cost of labor and the number of Medi-Cal patients that a nursing home serves.

Assume, for example, that a nursing home's total cost of providing care to one patient for one day (cost per patient day) in fiscal year 1981-82 was $36.80 and that $24.21 of that amount represented the cost of labor. In fiscal year 1982-83, that nursing home's cost per patient day rose to $38.59, of which $25.21 represented the cost of labor. The $1.00 increase in labor costs constitutes 56 percent of the $1.79 increase in total costs for the two-year period. Thus, if that nursing home used at least 56 percent of any increase in revenues to cover the 56 percent increase in labor costs, that nursing home would be using a "proportionate share" of its increased revenues.

The second factor we considered was the number of Medi-Cal patients that a nursing home served. If a nursing home serves only patients who are covered by Medi-Cal, then the nursing home operator would use increases in Medi-Cal revenues to cover all increases in costs. If only one-half of the nursing home's patients are Medi-Cal patients, only one-half of the total increase in costs would be covered by an increase in Medi-Cal revenues. Thus, assuming that the nursing home in our example served only Medi-Cal patients, if the nursing home operator received a $1.00 Medi-Cal COLA, that operator would use $.56 to pay for increased labor costs. If only one-half of the nursing home's patients were Medi-Cal patients, the nursing home operator would use one-half of $.56 or $.28 of the $1.00 Medi-Cal COLA to pay for increases in labor costs.

CHANGE IN ACTUAL COSTS PER PATIENT DAY BY SIZE OF NURSING HOME AND COST COMPONENT FISCAL YEAR 1981-82 TO 1982-83

	1981-82	1982-83	Change	Percent
1-59 Beds				
Salaries, Wages, Benefits	$24.18	$25.11	$ .93	3.8
Property Tax	.21	.27	.06	28.6
Fixed Cost	2.43	3.21	.78	32.1
All Other Costs	9.95	10.34	.39	3.9
Total	$36.77	$38.93	$2.16	5.9
60-299 Beds				
Salaries, Wages, Benefits	$23.57	$24.90	$1.33	5.6
Property Tax	.27	.28	.01	3.7
Fixed Cost	3.58	3.73	.15	4.2
All Other Costs	9.56	9.84	.28	2.9
Total	$36.98	$38.75	$1.77	4.8

APPENDIX C

AVERAGE INCREASE IN HOURLY WAGE PAID TO NONADMINISTRATIVE EMPLOYEES BY SIZE OF NURSING HOME FISCAL YEAR 1982-83

	Amount	Percent
1-59 Beds		
A	$ .06	1.6
B	.17	4.2
C	.05	1.3
D	.17	4.3
E	0	0
F	.12	3.2
G	.15	3.7
Average	$ .10	2.6
60-299 Beds		
H	$ .28	6.9
I	.27	6.9
J	.33	7.3
K	.39	9.6
L	.17	4.2
M	.19	4.7
N	.15	3.5
O	.22	5.4
P	.09	2.3
Q	.14	3.5
R	.10	2.5
S	.16	4.0
T	.25	5.8
Average	$ .21	5.1
Average, both sizes	$ .17	4.2

CHANGES IN NURSING HOME ADMINISTRATORS' SALARIES BY SIZE OF NURSING HOME FISCAL YEAR 1981-82 TO 1982-83

	1981-82	1982-83	Change	Percent
1-59 Beds				
A	$ 19,963	$ 21,001	$ 1,038	5.2
B	9,250	10,638	1,388	15.0
C	30,800	30,950	150	0.5
D	14,728	15,756	1,028	7.0
E	38,710	35,672	(3,038)	(7.8)
F	23,013	25,100	2,087	9.1
G	17,250	23,650	6,400	37.1
Average	$ 21,959	$ 23,252	$ 1,293	5.9
60-299 Beds				
H	$ 19,750	$ 35,100	$ 15,350	77.7
I	23,774	35,413	11,639	50.0
J	35,400	36,750	1,350	3.8
K	23,225	22,150	(1,075)	(4.6)
L	118,281	128,879	10,598	9.0
M	32,564	38,553	5,989	18.4
N	31,743	41,830	10,087	31.8
O	26,734	32,713	5,979	22.4
P	45,520	48,729	3,209	7.0
Q	38,856	40,000	1,144	2.9
R	92,300	98,900	6,600	7.2
S	15,371	16,020	649	4.2
T	73,575	51,199	(22,376)	(30.4)
Average	$ 44,392	$ 48,172	$ 3,780	8.5
Average, both sizes	$ 36,540	$ 39,450	$ 2,910	8.0

CHANGES IN PAYMENTS TO NURSING HOME OWNERS AND PARENT ORGANIZATIONS BY SIZE OF NURSING HOME FISCAL YEAR 1981-82 TO 1982-83

	1981-82	1982-83	Change	Percent
1-59 Beds				
A	$ 57,612	$ 62,464	$ 4,852	8.4
B	69,813	48,140	(21,673)	(31.0)
C	32,049	32,829	780	2.4
D	33,800	21,538	(12,262)	(36.3)
E	31,817	42,522	10,705	33.6
F	92,040	95,666	3,626	3.9
G	0,577	37,000	6,425	21.0
Average	$ 49,673	$ 48,594	$ (1,079)	(2.2)
60-299 Beds				
H	$ 54,292	$ 66,486	$ 12,194	22.5
I	115,399	119,409	4,010	3.5
J	25,179	41,898	16,719	66.4
K	83,862	80,200	(3,662)	(4.4)
L	118,281	128,879	10,598	9.0
M	185,122	196,224	11,102	6.0
N	161,070	93,448	(67,622)	(42.0)
O	100,559	104,681	4,122	4.1
P	70,049	79,095	9,046	12.9
Q	139,366	140,020	654	0.5
R	129,241	141,225	11,984	9.3
S	158,881	190,113	31,232	19.7
T	2,955	74,752	(18,203)	(19.6)
Average	$110,327	$112,033	$ 1,706	1.5
Average, both sizes	$ 89,098	$ 89,829	$ 731	0.8

cc: Members of the Legislature
Office of the Governor
Office of the Lieutenant Governor
State Controller
Legislative Analyst
Assembly Office of Research
Senate Office of Research
Assembly Majority/Minority Consultants
Senate Majority/Minority Consultants
Capitol Press Corps